Testimony of

America's Community Bankers

on

Interest on Business Checking Accounts

before the

Subcommittee on Financial Institutions & Consumer Credit

of the

Committee on Financial Services

of the

U.S. House of Representatives

on

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Mr. Chairman, Ranking Member Sanders, and members of the Subcommittee, my name is Edwin Maus. I am president and chief executive officer of Laurel Savings Bank, a $270 million institution in Allison Park, Pennsylvania.

I am testifying today on behalf of America's Community Bankers, where I serve as a member of ACB's Community Institutions Committee. Thank you for this opportunity to testify on the "Business Checking Freedom Act of 2003," legislation whose subject matter was first brought to the attention of Congress by ACB in 1994.

ACB strongly supports allowing banks to offer interest-bearing business checking accounts and urges the 108th Congress to pass H.R. 859, introduced by Representatives Pat Toomey (R-PA) and Paul Kanjorski (D-PA). We also support authorizing the Federal Reserve to pay interest on sterile reserves, as reflected in H.R. 758, introduced by Representative Sue Kelly (R-NY).

The existing ban on interest-bearing business checking accounts is the last statutory vestige of Regulation Q, an archaic law dating back to 1933. The law was originally intended to shield bank deposits from interest rate competition, which at the time was thought to be in the public interest.

Clearly, this prohibition is no longer needed. In its 1996 joint report, *Streamlining of Regulatory Regulations*, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision stated that the statutory prohibition against paying interest on demand accounts "no longer serves a public purpose." This statement lends additional authority to over twenty-five years of studies authorized by both the executive and legislative branches of the federal government consistently recommending that prohibitions against paying interest on demand deposits be removed.

By outliving its purpose, this prohibition has had a detrimental impact on community banking and small businesses in several ways. First, it has created an anti-competitive business environment allowing a limited number of financial conglomerates to corner the market for cash management services. Second, by discouraging businesses from creating demand deposit accounts at community banks, it has diminished our ability to lend to our neighbors and communities. Finally, it has prevented many small businesses from earning interest on their deposits.

Historically, the major beneficiaries of the ban on banks paying interest on business checking accounts have been a handful of large financial institutions. Unlike most community banks, these institutions have the financial resources to circumvent the prohibition by conducting so-called sweep arrangements. To better understand why this gives these institutions an unfair competitive advantage, it is worth examining what sweep arrangements involve.

There are essentially four sweep options that banks may offer, none of which, practically speaking, are viable for most community banks or the businesses they hope to serve:

Demand/Sweep Arrangements
This arrangement involves sweeping funds from a savings account into a demand account. Because the law limits the number of possible transfers per month, this approach is generally undesirable for most businesses.

Mutual Fund/Sweep Arrangement
Very large financial institutions can circumvent the law by controlling a bank and a mutual fund. Funds are swept daily from the bank to the mutual fund controlled by the bank. The mutual fund is not prohibited from paying interest, but because of a lack of competition, large banks frequently do not offer sweep services to all customers.

Third-Party Arrangements
Banks with sufficient commercial accounts and sweep transactions may use a third party, such as a mutual fund, for transfers. Because the third party is paying the interest, there is no technical violation of the law. However, smaller banks rarely have sufficient account volume or sweep activity to attract a "name" fund into which the swept dollars could be invested. Also, these third-party arrangements often encourage bank customers to seek service elsewhere, are less efficient and more costly than paying interest directly on demand accounts, and result in a loss of deposits necessary to support local lending.

Repurchase Agreements
Repurchase agreements, which generally involve the use of U.S. government securities, are labor-intensive and involve costly paperwork expenses. For most banks, particularly small- and medium-sized community ones, the benefits of repurchase agreements are simply not worth the costs and burden.

Sweep arrangements are often a costly and cumbersome product for a community bank to offer its customers. In fact, many institutions that offer sweeps today do so only because they are not allowed to pay interest on business checking accounts. Given the choice, they would select the more efficient and less costly option of paying interest on business checking accounts.

The interest on business checking option would also provide a stimulus for America's small businesses and the economy as a whole. Many small businesses do not earn interest on their demand deposits because they cannot afford to maintain the minimum level of deposits required for a sweep account. By lifting the ban on interest-bearing business checking accounts, Congress can give these small businesses the opportunity to finally earn a market rate of return on their demand deposits.

For many "mom n' pop" businesses, this could mean the margin of difference for surviving a weak economy. In addition, it would open up an entire segment of potential new deposits for community banks to lend to our neighbors and communities. Given the current debate in Washington over how best to revive the economy, doesn't a revenue-neutral economic stimulus tool like H.R 859 make all the more sense?

We think it does. And we're pleased to be joined in our support for this legislation by the National Federation of Independent Business, U.S. Chamber of Commerce, Association for

Financial Professionals, and Independent Insurance Agents of America. Repealing the prohibition against banks paying interest on business checking accounts also has consistently received the support of both the Federal Reserve and the Treasury Department.

Most importantly, this legislation was passed not just once, but twice, by the U.S, House of Representatives during the 107th Congress, and three other times before that. We hope that the House will follow suit this year with a strong vote in favor of this much needed legislation.

One critical issue that must be touched on with respect to this legislation is timing. In the past, much of the opposition to this change in law has been camouflaged under the guise of unreasonably long transition periods. Since this issue was first brought to the attention of Congress, institutions have had ample time to make any needed changes to their systems, operations, and business plans. There is also precedent for a shorter time interval: the 1980 law permitting banks to pay interest on consumer checking accounts (PL 96-221) took effect nine months after it was signed into law by the President.

Because a delay would only postpone the benefits of this much-needed new deposit product, ACB would strongly prefer that legislation lift the ban immediately upon enactment. We believe, however, that the one year phase-in contained in H.R. 859 represents an acceptable compromise to address any remaining concerns about a transition period. We strongly urge Congress not to extend this phase-in period beyond one year.

We are also aware that a small, but vocal pocket of our community bank brethren does not see eye-to-eye with us on this issue. As a fellow community banker, I cannot understand the opposition of this group to the option of offering a better product to potential business customers. Today's world of financial services is much different than that of the 1930s. The evolution of capital markets and the expanded availability of mutual funds give both consumers and businesses a number of low-risk alternatives to deposit accounts. As a result, community banks face stiff competition for the business of deposit-taking. Allowing us to offer an efficient demand deposit product like interest-bearing business checking accounts is a forward-looking approach to addressing this problem.

Let me remind my fellow community bankers that H.R. 859 does not require banks to pay interest on business checking accounts; we simply want the option of doing so. If a bank would choose not to offer such a product, that's fine. But please don't stand in the way of those of us who would.

I would also like to take this opportunity to express ACB's support for legislation authorizing the Federal Reserve Board to pay interest on sterile reserves held at the Federal Reserve Banks. This implicit tax creates incentives to adopt sweep arrangements on demand deposits that are not subject to reserve requirements. Paying interest on required reserve balances will increase the effectiveness of monetary policy and help make a bank's payment of interest on its business checking accounts more feasible. On behalf of ACB, I would like to commend Representative Kelly for her ongoing efforts on this issue.

ACB strongly endorses H.R. 859, the "Business Checking Freedom Act of 2003," an important step for community banks, small businesses and the American economy. We thank Representatives Toomey and Kanjorski for their sponsorship of this critical legislation and urge Congress to pass it immediately.

Thank you again for the opportunity to testify before the Subcommittee, and I look forward to any questions you may have.